REGULAR MEETING

PUBLIC EMPLOYEES' RETIREMENT BOARD

SEPTEMBER 23, 2004

The regular meeting was called to order by President Teichrow at 8:30 a.m., in Miles City. Thursday, September 23, 2004. Roll call was taken with all members of the Board being present. Board members and staff present were:

Terry Teichrow, President
Carole Carey, Vice President
Robert Griffith, Member
Betty Lou Kasten, Member
Jay Klawon, Member
Troy McGee, Member
Jim Pierce, Member
Kelly Jenkins, Counsel
Melanie Symons, Counsel
Mike O'Connor, Executive Director
Linda Owen, Secretary

OPEN MEETING

Mark Johnson, Milliman USA; Terrence M. Smith, Big Sky County Water and Sewer District; Perry Christie, Great-West Life; Rick Ryan, Scott Moore, Jack Trethewey, Ed Regele, and Dale Berg, members of the Montana State Firemen's Association, joined the meeting.

MINUTES OF OPEN MEETING

The Executive Director presented the minutes of the open meeting of August 26, 2004. Mrs. Carey moved that the minutes of the previous open meeting be approved. Mr. Griffith seconded the motion, which upon being submitted to vote, was duly carried with the seven attending members voting aye.

Public Comment – Terry Smith, with Big Sky County Water and Sewer District, thanked the Board for their assistance this past year. He has not been convinced that some of the positions he has taken are wrong, but he did appreciate the Board’s help.

EXECUTIVE DIRECTOR’S REPORT - Mike O'Connor

Actuarial Experience Study – Mark Johnson, Consulting Actuary – Mr. O’Connor noted an experience study should be done every four or five years. The actuary looks at both the economic and demographic information and reports how the Board stands on the assumptions they have adopted. This is a prelude to the actuarial valuation that will be done after reviewing actual experience of the plans compared to the actuarial assumptions being used.

Mark Johnson, with Milliman USA, presented his findings of the Actuarial Experience Study. His report reviewed actuarial methods; economic assumptions, which are more global in nature; and demographic assumptions, which are very specific to the membership of the retirement systems. The 2004 Actuarial Valuations will be compiled after the completion of the Actuarial Experience Study.

Mr. Johnson began his presentation pointing out the actuarial valuations will become the cornerstone for analyzing the funding status of the systems, for analyzing the sufficiency of employer contributions rates, for disclosing employer liabilities on financial statements, and for analyzing the fiscal impact of proposed legislative amendments. Mr. Johnson addressed the actuarial cost method and the asset valuation method used to process the data and to determine the funded status and appropriate contribution rates. The only change recommended in the actuarial methods used in the valuations is the amortization period for the Volunteer Firefighters' Compensation Act (VFCA).

Mr. Johnson explained that the Entry Age Cost Method is used to predict the cost of the system as a level percentage of pay. That is when somebody enters the system, that level percentage of pay would be sufficient and pay all the way through his or her career, to fund the entire retirement benefit. That is called a "normal cost," the average cost of benefits. When an evaluation is performed, figures are not going to be precisely where assumed to be. If they are behind where assumed to be, this is called an "unfunded liability." An effort is made to keep contributions stable. This cost method is an effort to produce stable contribution rates as a percentage of payroll.

When analyzing an unfunded liability, consideration is given to whether the contribution rate, established by legislation, can finance the system over 30 years. Will the contribution coming in pay the normal cost, plus pay the additional amount that might be necessary to amortize an unfunded liability over 30 years? Mr. Johnson stated, the reason we want to stay at 30 years and not go any higher than that is because if we did, we would also have to calculate a 30-year amortization for the Governmental Accounting Standards Board (GASB).

The VFCA has had a declining amortization period. Because no payroll is obtained for volunteer firefighters, the amortization schedule for the VFCA is based on an increasing dollar amount each year based on the rate of price inflation, rather than the rate of general wage inflation. There are insurance premiums to help pay for the VFCA pension plan. The majority of the insurance premiums go into the General Fund; only 5% is used to fund the VFCA. If the state wants to add more people to this plan, another revenue source would need to be found. It is not prudent to let the amortization decline too far because it would produce more volatility in the sufficiency test for the contributions. Mr. Johnson's recommendation is to keep the amortization at a 20-year fixed period.

The asset smoothing method recognizes investment gains or losses over the four years subsequent to the valuation date. To calculate the investment gain or loss, the expected Fair Value of Assets is calculated at the end of the year, based on the beginning of year Fair Market Values and the cash flow during the year. That gain or loss is not just whether you gained money or lost money, it is how much you made compared to the assumption, which is currently 8%. If you earned 7%, that is a loss. One-quarter of that will be recognized in each of the next four years. Mr. Johnson is not recommending any modifications to the asset smoothing method.

Economic assumptions include inflation, wage growth and investment returns. Because no one knows what the future holds, the best an actuary can do is to use professional judgment to estimate possible future economic outcomes. Recognizing there is not one “right answer,” the standard calls for the actuary to develop a best estimate range for each economic assumption, and then recommend a specific point within that range. A precept of the standard is to not give undue weight on recent experience.

Mr. Johnson explained how he arrived at his recommendation to stay at 8%. Inflation has an impact on both the wage growth and the investment returns. The current assumption for inflation is 3.50% per year. To find an economic forecast with a long enough timeframe, Mr. Johnson said he takes into consideration the expected increase in the CPI by the Office of the Chief Actuary for the Social Security Administration (SSA). He agreed with the Social Security projections that a range between 1.8% and 3.8% is reasonable for an actuarial valuation of a retirement system. Mr. Johnson recommends the long-term assumed inflation rate be reduced from 3.50% to 3.25%. It does not affect the liability side, but it does affect the wages.

The current wage growth assumption is 1.00% above inflation, or 4.50% per year. Over a long period of time, even if there are periods where you are lagging behind wage inflation, you will eventually catch up. Wage growth minus inflation equals the productivity growth or real wage growth. Mr. Johnson concurs with the SSA Actuary that a range between 0.60% and 1.60% is reasonable for the actuarial valuation, and recommends the long-term assumed real wage inflation rate be retained at 1.00% per year. Due to the recommendation that the inflation assumption be lowered from 3.50% to 3.25%, the total wage inflation rate will also decrease from 4.50% to 4.25% per year. The impact of this change will generally be a reduction in liabilities.

Mr. Johnson stated the investment return assumption is, by far, the most powerful assumption. It is one of the primary determinants in the allocation of the expected cost of the systems’ benefits, providing a discount of the future benefit payments to reflect the time value of money. The lower the interest rate used to discount that, the higher the liability. The basic universal equation is that, over a long period of time, the contributions need to be equal to the benefits paid, plus expenses, minus the investment returns. If the assumption is changed on future investments and it is lowered, to keep the equation down, contributions would have to be increased. The current assumption for investment return is 8% per year, net of all investment-related and administrative expenses.

The expense ratio is calculated as the total expense divided by the average asset balance during the year assuming uniform cash flows. Based on the data provided, the annual investment and administrative expenses represent about 0.2% of the systems’ assets. Mr. Johnson concluded that a reasonable range for the total rate of investment return is from 6.2% to 9.9%, including inflation at 3.25% per year. This range is lowered to reflect the expenses assumed to be paid from the investment return (0.2%). Mr. Johnson believes that a range of 6.0% to 9.7% is reasonable for an actuarial valuation of a retirement system with the current Board of Investments asset allocation policy.

Mr. Johnson stated an investment return assumption of 8.0% per year is consistent with the level of inflation and real rate of return likely to occur over an extended period of time, net of expenses. An 8% assumed rate means the assumed real rate of return is 4.79% per year. This falls in the 52nd percentile on the distribution of returns based on the selected assumption set. Therefore, the Board could expect to earn a real rate of return of at least 4.79% over a 30-year period about 48% of the time. Based on the input from several sources and independent analysis, Mr. Johnson recommended that the net investment return assumption remain at 8.0% per year.

Mr. Johnson addressed the demographic assumptions, which have to do with the behavior/change in membership status of the members of the systems. This would include mortality, service retirement, disability, and other terminations of membership. The purpose of a study of demographic experience is to compare what happened to the membership during the study period with what was expected to happen based on the assumptions used in the most recent Actuarial Valuation. If the actual experience differs significantly from the overall expected results, new assumptions are considered.

Mortality or life expectancy has changed; people are living longer than they used to. If people live longer than what is "assumed," that would increase the actuarial liability. When an assumption is used to fit retirees, that same life expectancy table is used to measure how long benefits will be paid for members who are not yet retired, as well. Part of the game plan in a valuation is to try to get the contributions to pay for the benefits over a member's working lifetime, not after.

In the previous experience study, the mortality assumption was adjusted according to observed data and it was found that, particularly for the males, fewer deaths are being experienced than was anticipated. This issue affected males more than females, and the uniformed groups were affected the most. Deaths for female uniformed members were not studied because the data set was too small to be credible. The actuary's recommendation was to retain the current mortality assumption for PERS females and to adjust the mortality for the two male groups. The assumption for the PERS females still contains a 5% margin, but the changes for the males are enough to warrant a modification to put some margin back in the assumptions.

The recommendation is to add a one-year adjustment to the PERS male mortality table and to add a two-year adjustment to the uniformed male mortality tables. The impact of this recommendation would be an increase in the actuarial liabilities due to the expectation of a different pattern of mortality, including longer life expectancies for male members.

There is never complete data on the mortality experience of beneficiaries prior to the death of a member because there is no expectation that the death will be reported to MPERA. The recommendation is a continuation of the assumption that beneficiaries exhibit the same mortality patterns as healthy PERS retirees, which is a standard convention. Therefore, the mortality for male beneficiaries will be changed.

The valuation assumes that disabled retirees, in general, will not live as long as service retired members. As with the healthy retiree mortality, fewer deaths were reported than expected. The recommendation was that two years be subtracted from the disabled mortality assumption for PERS members. No change is recommended for the uniformed service members. Due to the volatility in disabled mortality, and the fact that the number of observed deaths was relatively small, the mortality was not adjusted to add any further margins. Disabled mortality will be closely monitored in the future.

For active members, there were not a sufficient number of pre-retirement deaths to credibly measure this assumption. Therefore, the selection of an assumption based on experience with other systems was recommended. The actuary recommended a continuation of the assumption that active members exhibit the same mortality patterns as healthy PERS retirees. The mortality for active members would be changed to reflect the modifications to the retiree mortality.

Revisions to the assumed mortality of retirees and beneficiaries were recommended and the actuary will present recommendations for modifications to the current Actuarial Equivalency Factors in the near future.

Retirement rates for active membership in the Defined Benefit Plan, overall, were down in the four-year observation period, but there were higher rates for several of the systems. The relatively smaller size of the uniformed systems means more volatility is expected. The actuary's recommendation was to retain the current assumptions for the uniformed systems. The actuary recommended a slight revision to the retirement rates for PERS members, from ages 55 through 59, who retire with less than 30 years of service. The remainder of the rates at the other ages will stay the same.

The percentage of members electing the DROP was 33% in the 2003-04 year, although this statistic was not based on a significant amount of credible data. The actuary recommended that the valuation include an assumption that 33% of the members elect to participate in the DROP at the attainment of 20 years of service. Because predictions about the MPORS DROP are based on very little data, the assumptions will continue to be monitored.

Disability rates have fluctuated from study to study, and because the numbers are so small, the recommendation was to retain the current assumptions.

The overall results for 1999-2003, for terminations, are fairly consistent with the revised assumptions recommended in the last study for PERS. Therefore, the actuary is not recommending any changes for PERS. The other systems will continue to be monitored and except for GWPORS, no changes are recommended to the withdrawal assumptions at this time. The GWPORS is different because of the impact of the transfer of employees from the PERS to the GWPORS, and the actuary recommends adjusting the turnover rates. This would reduce the normal cost and the unfunded liability.

The probability of refunds is an area is important when members quit and take a refund and they are vested, because these are gains and no retirement benefits are paid out. The observed data in the last four years indicated 50% of members under age 35, who were vested, refunded their money. Expected rates for the probability of refunds were consistent with the actual experience and no changes are recommended except for minor adjustments in PERS.

No changes were recommended to the merit salary scale at this time.

What impact would the adoption of these changes that were addressed have on the valuation? Mr. Johnson felt there should be no significant impact. However, it will be calibrated in the valuation what impact these changes will have on the unfunded liability. The valuations will be prepared for the November 12 Board meeting.

Mr. Klawon made a motion to accept the recommendations of the actuary. Mr. Pierce seconded the motion, which upon being submitted to vote, was duly carried with the seven attending members voting aye.

Board Legislation – Mr. O'Connor reviewed the Board's General Revisions bill, particularly addressing the education program. The objective of revising the statute is to provide language that would not hinder the Board in their ability to provide all members with the best type of educational services in planning for their retirement. It will address transfer education, as well as ongoing education for both the Defined Benefit and Defined Contribution retirement plans.

The legislative intent of the DC plan was to make sure there was unbiased plan choice educational information provided for members to make informed personal decisions. If a vendor provides ongoing transfer educational information, and they also provide other services, there could be the appearance they may be biased. If those services are contracted out to a vendor who does not have a vested interest in one or the other plans, it would show it as an unbiased educational program.

Mr. Pierce made a motion to adopt the General Revisions retirement bill draft. Mr. Klawon seconded the motion, which upon being submitted to vote, was duly carried with Mrs. Carey, Mrs. Kasten, Mr. Klawon and Mr. Pierce voting aye, and Mr. Griffith, Mr. McGee and President Teichrow voting nay.

The Actuarial Funding bill addresses the Public Employees' Retirement System (PERS), Game Wardens and Peace Officers' Retirement System (GWPORS), and Sheriffs' Retirement System (SRS), and will bring these systems into compliance with being actuarially sound. This bill includes a phase-in of increased employer contributions needed in PERS, over a three-year period beginning July 1, 2005. The same applies to GWPORS and SRS. This bill would also change the definition of highest average compensation (HAC) for new hires only, changing it from the highest 36 months to the highest 60 months of service, used in the calculation of retirement benefits.

The Board did not take any action on the Board's Actuarial Funding bill.

Mr. O'Connor presented a bill draft for the funding of the start-up costs for the DCRP, asking the legislature to repay the loan balance of $1.4 M. The Governor's Office has not approved this bill, so the Board will have to obtain a sponsor. Staff was required to submit the General Revisions and Actuarial Funding bills to the Budget Office by September 15, 2004. Mr. Pierce questioned why the entire amount of $1.5 M is not being requested. Mr. O'Connor stated that the Board is showing a "good faith effort" to pay back the loan and asking the legislature to pay off the principal balance still owing.

Mrs. Kasten made a motion to adopt the startup costs/loan bill draft. Mrs. Carey seconded the motion, which upon being submitted to vote, was duly carried with six of the attending members voting aye, and Mr. Pierce voting nay.

EIAC Appointments – At the September Board meeting each year, the Board is responsible to appoint or reappoint members to the Employee Investment Advisory Council (EIAC). 25% of the EIAC members, or four positions, have their term of office expire each year. The four existing members, Pam Fleisner, Jim Christnacht, Kevin McRae, and Terry Smith, have all shown an interest in being reappointed. Jim Helgeson, with the Great Falls Transit, also has interest in becoming a member of EIAC.

Five of the seven local government position members must be in the 457 or Defined Contribution plans. The Great Falls Transit is unique in that it is the only agency that contributes employer contributions into the 457 Plan, using it as their sole retirement package for employees. Either Terry Smith or Jim Helgeson could fill the local government position.

Lorraine Reid will be retiring and will no longer be eligible for her position on the council. Mr. O'Connor recommended Rick Soto, City Treasurer from Butte-Silver Bow, to replace Lorraine Reid to finish out her term. Jim Penner, the Board of Investments (BOI) member, will be retiring. The BOI recommended Carroll South replace Mr. Penner to finish out his term.

Mr. Klawon made a motion to reappoint the four existing members to EIAC, Rick Soto, and Carroll South. Mrs. Carey seconded the motion, which upon being submitted to vote, was duly carried with the seven attending members voting aye.

PERS Contract - The Executive Director presented a contract to extend PERS coverage to employees of Miles City Housing Authority. Mr. McGee made a motion to accept the PERS contract. Mr. Griffith seconded the motion, which upon being submitted to vote, was duly carried with the seven attending members voting aye.

The Executive Director presented a contract to extend PERS coverage to employees of Elliston Elementary School. Mr. McGee made a motion to accept the PERS contract. Mr. Griffith seconded the motion, which upon being submitted to vote, was duly carried with the seven attending members voting aye.

Contested Case Update – Mr. Jenkins addressed the Supreme Court Opinion in the Joseph Baumgardner case.

The Supreme Court did not grant the Board's Writ of Supervisory Control over the Baumgardner case. It was sent back to District Court to obtain more information on the impairment of contract claim. No petition for rehearing on the Request for Supervisory Control has been filed. The Supreme Court also did not address the issue of legislative delegation of authority and whether the legislature had delegated too much authority to the Board, in determining the actuarial option factors.

Litigation strategy will be discussed in the closed meeting. The motion is waiting to be filed in court today (September 23, 2004).

Great-West Retirement Services – Perry Christie addressed the Board, explaining Great-West Life's (GWL) profile series review process. There is an investment board at GWL that reviews the profiles to determine which asset classes to include. This review process is done on a quarterly basis.

Basically, the asset classes are defined first. Then it is determined how to invest within those asset classes. Three different components are considered for both selecting and removing funds:

1) Returns – Returns are reviewed over 3-, 5-, and 10-year periods. A particular fund is compared to its peer group, to try to determine if the returns are in excess of 50% of what the peer group would do.

2) Risk – The risk is compared to its peer group, looking for performance. What kind of risk is being taken to get the same kind of return? ~~From that, a scorecard~~

3) Scorecard – A scorecard will be created with an overall composite of a fund. Above 66% will have a positive rating; above 50% is neutral; below 50% is failing. One criteria used is the Morning Star ratings, which is independent of GWL.

Mr. Christie stated that GWL has begun to expand the number of funds used in their profiles because they want growth, blend and value wherever possible. The more you have, the more diversified your asset classes are.

Future Board Meetings – Friday, November 12 and Thursday, December 9, 2004.

Operational Summary Report - The Executive Director presented an operational summary report for the month of August 2004, answering any questions Board members had.

The following portion of the meeting relates to matters of individual privacy. President Teichrow determined that the demands of individual privacy clearly exceed the merits of public disclosure. As such, this portion of the meeting will be closed.

CLOSED MEETING

Contested Case Update – Mr. Jenkins addressed the litigation portion of the Joseph Baumgardner case. Following a lengthy discussion, it was the consensus of all seven Board members that Mr. Jenkins proceeds as he outlined.

MINUTES OF CLOSED MEETING

The Executive Director presented the minutes of the closed meeting of August 26, 2004. Mr. Griffith moved that the minutes of the previous closed meeting be approved. Mr. Pierce seconded the motion, which upon being submitted to vote, was duly carried with five of the attending members voting aye, and Mr. Klawon abstaining because he was not present during the closed portion of the August meeting. Mr. McGee was not present for the vote.

Contested Case Report Update - The Board Attorneys presented a contested matter status report update.

RETIREMENT REPORT

Disability Claims - The Executive Director presented the disability claims for Board consideration. Mr. Pierce made a motion for approval of the disability claims as recommended for Lewis Hasbrouck, with annual review; for Lanette Sand and Jerry Martell, without annual review; and denying the claims for Nola Luckey, John Traver, and Christina Foley. Mr. Griffith seconded the motion, which upon being submitted to vote, was duly carried with the seven attending members voting aye.

Disability Reviews - The Executive Director presented the disability reviews to the Board. Mrs. Carey made a motion to approve the disability reviews as recommended: to continue disability retirement and continue annual review for Martha Jane Kingsbury; to continue disability retirement and discontinue annual review for Gordon Barthel and Jeromer Stradinger; and to request an IME at the Board's expense for David R. Holcomb. Mr. Pierce seconded the motion, which upon being submitted to vote, was duly carried with the seven attending members voting aye.

Finalized Service/Disability Retirement Benefits, Monthly Survivorship/Death Benefits, and Funeral Benefit - Applications for service retirements/finalized disability benefits, applications for monthly survivorship-death benefits, and an application for a funeral benefit were presented to the Board. Mr. Griffith made a motion to approve the retirement benefits as presented. Mrs. Carey seconded the motion, which upon being submitted to vote, was duly carried with the seven attending members voting aye.

ADJOURNMENT

There being no further business to come before the Board at this date, Mr. Griffith made a motion to adjourn the meeting. Mr. McGee seconded the motion, which upon being submitted to vote, was duly carried with the seven attending members voting aye. The next meeting is tentatively scheduled for Friday, November 12, 2004, at 8:30 a.m. in Helena.